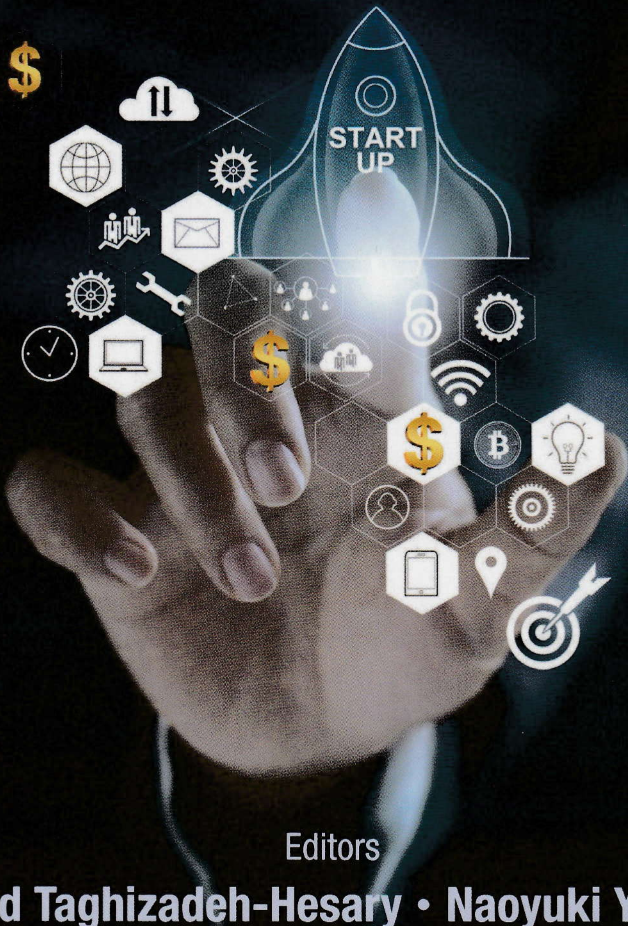
World Scientific Series in FINANCE vol. 17

Investment in Startups and Small Business Financing



Editors

Farhad Taghizadeh-Hesary • Naoyuki Yoshino

Chul Ju Kim • Peter J Morgan • Daehee Yoon

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Published:*

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Korea Credit Guarantee Fund, South Korea

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https://doi.org/10.1142/9789811235825_0010

Chapter 10

Leveraging the Potential of Islamic Banking and Finance for Small Businesses

Mohamed Asmy Bin Mohd Thas Thaker[*,¶],
Hassanudin Bin Mohd Thas Thaker[†,‖],
Anwar Bin Allah Pitchay[‡,**], Md Fouad Bin Amin[§,††],
and Ahmad Bin Khaliq[*,‡‡]

[*] *International Islamic University Malaysia Kuala Lumpur, Malaysia*
[†] *Sunway University, Malaysia Kuala Lumpur, Malaysia*
[‡] *Universiti Sains Malaysia Penang, Malaysia*
[§] *King Saud University, Riyadh, Saudi Arabia*
[¶] *asmy@iium.edu.my*
[‖] *hassanudint@sunway.edu.my*
[**] *anwarap@usm.my*
[††] *fbinamin@ksu.edu.sa*
[‡‡] *ahmadkhaliq@iium.edu.my*

Abstract

Small businesses are considered one of the sources of innovation, productivity, and dynamism in many countries. Thus, to translate innovative ideas into sustainable businesses, access to capital becomes a part and parcel of the business lifecycle of small businesses. Despite their potential importance for economic development, small businesses are facing difficulties in attracting external finance at the early and middle stages of the entrepreneurial lifecycle in many countries, including developed and developing countries. Islamic banking and finance is a broad framework that has great potential for supporting development finance particularly related to small business, given their fundamental criteria emphasizing generating positive societal impact. The main objectives covered by this chapter are: (i) to identify and unpack innovative financing opportunities within Islamic banking and finance instruments such as Mudharabah (profit-sharing), Musharakah (profit–loss sharing), Murabahah (sale with cost plus profit margin, Ijarah [Islamic leasing]), and Salam (forward sale) as potential solutions for addressing small businesses' funding gaps; and (ii) to initiate the development of systematic principles for the utilization of Islamic banking and finance instruments in financing small businesses.

Keywords: Small businesses, financing, Islamic banking and finance, Malaysia, Indonesia

1. Introduction

Small businesses or micro-based businesses are considered one of the best potential platforms for innovation, productivity, and dynamism that support many economic sectors through employment creation, output expansion, export orientation, and income increases (Wong and Aspinwall, 2004). Furthermore, these businesses are also dominating various strategic business service subsectors, including services related to computer software and information processing, research and development, marketing, business organization, and human resource development (OECD, 2000). It is estimated that small businesses represent about 95% of the companies providing more than 65% of the jobs as well as more than 50% of the gross domestic product globally (World Trade Report, 2016). Hence, these businesses occupy a prominent position in the development agenda and essentially become a part of the overall national development strategy in most countries (Abdullah, 1999). Both developed and developing countries acknowledge the role of small businesses as the primary contributors to the growth and development of an economy.

Despite their potential importance for economic development, it is widely recognized that small businesses are facing difficulties in attracting external finance at the early and middle stages of the entrepreneurial lifecycle in many countries, including developed and developing countries. According to the World Bank Report (2015), small businesses in developing countries lack financial support to reach their optimal capacity. Existing empirical studies found that collateral condition, legal status, transaction cost, information and documentation, financial track record, nature and quality of business, and financing procedures and options are among the challenges of small businesses in accessing external financing (Hashim, 1999; Aris, 2006; Saleh and Ndubisi, 2006; Abdullah and Manan, 2010; SME Masterplan, 2012–2020; Thaker *et al.*, 2013; Thaker, 2015; Duasa and Thaker, 2016). In addition, lack of attraction and the uncertainty of cash flows are also becoming limitations for them in accessing external finance (Block *et al.*, 2018).

Islamic banking and finance industry is a broad framework that has great potential for supporting development finance particularly related to small businesses, given their fundamental criteria emphasizing generating positive societal impact. It has achieved remarkable success in terms of steady growth and product diversification across the world. According to a report by the Islamic Financial Services Board (2018), the industry has experienced a compound annual growth rate of 5.5% from 2018 and its total assets are projected to grow to US$3.5 trillion by 2024.[1] To be more specific, Islamic banking's total assets across the industry grew to US$2.52 trillion in 2018 from US$2.46 trillion previously.[2] The two most notable features of Islamic banking and finance that contribute to social and economic development via entrepreneurship are asset-backed financing and risk-sharing.

According to the policy paper jointly released by World Bank Group, Islamic Development Bank, and the G20 in 2015, the Islamic financial industry should be asset-based so that it can boost real economic activity that will be directing factors of production to the growth of financed assets

[1] https://themalaysianreserve.com/2020/01/13/global-islamic-finance-growth-slows-to-3-in-2018/ (Retrieved on September 29, 2020).
[2] https://themalaysianreserve.com/2020/01/13/global-islamic-finance-growth-slows-to-3-in-2018/ (Retrieved on September 29, 2020).

and eliminating the stigma of "financialization" of a particular economy (World Bank-IDB, 2015). Another key financial mechanism of the industry is that it is based on equity suitable for small businesses because the entrepreneurs can share profits and losses. This risk-sharing mode is a fundamental support for entrepreneurial development, particularly small business entrepreneurs relying on equity financing for their new ventures.

The financial products offered by Islamic financial institutions are subject to the teaching of Islam (the Shariah), which are governed by two primary sources — the Quran and the Sunnah of Prophet Muhammad (pbuh). According to the Shariah law, taking or giving interest are prohibited and it is the most important feature of Islamic banking. Therefore, most of the financing sources are developed based on profit sharing and fee-based financing which are in compliance with Shariah laws. This mode of financing has been applied in retail, private, and commercial banking for debt and capital market, insurance, asset management, structured and project financing, derivatives, etc. Distinguished from their conventional counterparts, all Islamic financial instruments in general must meet a number of criteria in order to be considered halal (acceptable). According to Komijani and Taghizadeh (2018), and as also cited in Moosavian (2007), the main features that distinguish Islamic banking and finance from conventional paradigms are as follows:

- Riba: Prohibit taking or giving interest rate
- Maysir: Involvement in gambling or speculative type of business and transaction are strictly prohibited
- Gharar: Uncertainty about the term of contract or the subject matters are prohibited
- Undesirable: Should not involve any type of businesses which deal with alcohol, gambling, etc.
- Real economy: Activities by sharing risks and rewards.

In Malaysia, a number of institutions participate in fostering financing accessibility, focusing on SMEs, include commercial banks, Islamic banks, merchant or investment banks, and development finance institutions (Bank Negara Malaysia, 2019). According to BNM, a total amount

of RM2.17 billions of loans/financing disbursed was recorded by all the participant banks as of November 2019. Meanwhile, in the last 5 years, Indonesia's Shariah banks have seen their assets grow by 38% compared to 15% for conventional banks (Bank Indonesia). The sector is currently dominated by two leading players, namely Bank Mandiri Syariah and Bank Muamalat, which account for 50% of total Shariah financing between them (Global Business Guide-Indonesia, 2011).

Considering the importance of small businesses and the scope for Islamic financial services, the present research aims to achieve the following objectives:

(i) to perform a landscape analysis of financing small businesses in selected Asian countries particularly Malaysia and Indonesia;
(ii) to identify and unpack innovative financing opportunities within Islamic banking and finance instruments, such as Mudharabah (profit-sharing), Musharakah (profit–loss sharing), Murabahah (sale with cost plus profit margin, Ijarah [Islamic leasing]), and Salam (forward sale) as potential solutions for addressing small businesses' funding gaps; and
(iii) to initiate the development of systematic principles for the utilization of Islamic banking and finance instruments in financing small businesses.

There are two important contributions from these findings. Firstly, from a theoretical perspective, it contributes significantly in offering alternative techniques for SMEs in Malaysia and Indonesia which are rarely available in the existing literature. Further distinguished factor would be the incorporation of Islamic finance/banking products in the model make the model even more outstanding than the conventional models. Most of the past studies tend to focus on the conventional models instead of alternative models such as Islamic mode of financing. Given these facts, thus, this study will help to enrich and add value to the existing literature within the context. Secondly, from a managerial perspective, this study offers the following points: (i) an alternative model to mitigate financial accessing problem of small businesses, and (ii) flexible system and proper modus operandi of Islamic banking and finance products.

The implications from this study may benefit various stakeholders such as policy makers, governments, financial institutions, and investors.

2. Literature Review

2.1 *Issues of Financing Small Businesses*

The extant studies have shown that small businesses are facing the most common problem, which is financial challenges. In general, the majority of the studies have indicated the factors that prevent small businesses from accessing external financing are strict collateral requirements, high transaction costs, lack of response from financial institutions that consider the small business as a risky business, insufficient documents to support the loan application, and no financial track record.

Aris (2006) studied various challenges of external finance for small businesses in Malaysia, which are lack of collateral, insufficient documents to support loan applications, no financial track record, the nature of the business, and long loan processing time. These factors cause them to rely much more on internal financing rather than external financing.

Hassan (2015) described the various financial challenges of micro entrepreneurs in Malaysia and observed that most of the micro entrepreneurs experienced extreme financial difficulties in the initial stage of their businesses. They also found that the rigidity of the procedures for accessing financial programs also prevented the smooth success of the programs.

Subramaniam (2010) investigated the challenges faced by the youth in micro enterprises in Malaysia. Her results revealed that lack of access to external financing was a major factor that led them to rely more on internal financing.

In their study, Hassan *et al.* (2011) argued that most of the micro enterprises in Malaysia were restricted from accessing external financing because of lack of collateral and insufficient documents to support their loan applications. Indeed, the financial providers were reluctant to increase the initial loans due to the risk and uncertainty involved in the business.

Meza (2012) examined the financial barriers to financial assistance by micro enterprises in Malaysia and Cost Rica by conducting in-depth personal interviews with micro entrepreneurs. The author found that public banking institutions in both Malaysia and Costa Rica failed to provide sufficient financing without collateral needed to meet the financial requirement to run micro enterprises. As a result of this, micro entrepreneurs most of the time depended on their own or informal sources of financing.

Machmud and Huda (2011) explored the financial challenges of small businesses in Indonesia and they claimed a major challenge for their entrepreneurial development was the rising costs of business. The authors also identified three key causes of unsuccessful loan applications which were related to: (i) business plan; (ii) sales, revenue, and cash-flows; and (iii) credit history.

In his study, Tambunan (2011) critically examined the constraints of small businesses in Indonesia. By using secondary data of small businesses, the author pointed out that lack of financing is one of the top constraints, followed by lack of marketing, innovation, and skilled human capital resources.

Rahman (2010) discussed the financial constraints in Bangladesh among the small businesses. The author found that the high requirements for collateral and improper project planning also resulted in the lack of access to finance for small businesses in Bangladesh.

In his study, Das (2007) claimed that Indian small businesses have for decades continued to be hindered by constraints, particularly access to loan financing. The author pointed out that there were inadequate flows of funds, causing a specific bias against small loan portfolios that interrupted the normal flow of finance to small firms. The two most responsible factors — collateral condition and the lack of transparency — are identified as the main impediments to small businesses' receiving external financing.

In another study on Thailand, Punyasvatsut (2011) mentioned a number of obstacles related to financing that arose from both entrepreneurs and financial institutions. Regarding the financial institutions, SME entrepreneurs claimed to have inadequate information, insufficient advice from financial institutions, as well as complex and cumbersome loan application processes, whereas the entrepreneurs were observed to have constraints related to collateral, business experience, business plans, loan history, and transaction costs that prevented them from accessing finance.

Kyophilavong (2011) examined the financial constraints of small businesses in the Lao People's Democratic Republic and identified that all entrepreneurs of SMEs more or less experienced critical problems in accessing required finance at the early stages of their businesses. The author highlighted that majority of the entrepreneurs were dissatisfied with the existing terms and conditions of the financial institutions, and most of them had common complaints about the institutions' collateral conditions, lengthy and complex application processes, and insufficient information.

Ung and Hay (2010) focused on the various financial challenges faced by small businesses in Cambodia. They revealed that the small entrepreneurs were kept mostly out of the financing mechanism because of non-fulfillment of collateral conditions. Furthermore, the authors identified a few other negative factors responsible for financial inaccessibility, such as loan amount, interest rate, and repayment periods. It was suggested that unbiased lending principles of financial institutions can support the expansion of micro-sized firms in Cambodia.

Thanh *et al.* (2011) investigated the factors responsible for slow development of small businesses in Viet Nam, especially in the textiles and garment, electrical and electronics, and automotive components manufacturing industries. The authors found that capital inadequacy was one of the major obstacles to the development of small businesses. Similar to many other studies as outlined above, the authors also indicated a number of constraints related to accessing finance by the entrepreneurs of small businesses such as collateral, age of the enterprise, business experience, small size, and production networks.

Aldaba (2010) highlighted the difficulties faced by small businesses in accessing finance in the Philippines. The author surveyed a total of 97 firms in the textiles, garments, electrical and electronics, automotive, and food manufacturing industries. The author found that financial challenges were one of the most important ones that restricted the growth of small businesses. In most cases, small business entrepreneurs manage their startup capital by using internal sources, and the rest of the capital comes from the banks.

2.2 *The Role of Islamic Banking and Finance in Small Businesses' Financing*

Islamic banking and finance are widely known as banking systems focusing their operations and activities purely based on Shariah rules and regulations. Since 1960, the progression of Islamic banking and finance has been undeniably significant and continues to grow at peak levels and to compete against conventional counterparts who have been in existence for the last 420 years.

The spirit of an Islamic enterprise, however, distinguishes an Islamic bank from a conventional bank. Khan (1997) points out that different variants of conventional financial institutions (like mutual funds, Rental Equity Participation Trusts, etc.) appear very close to Islamic modes of financing, but this doesn't make these institutions Islamic. He asserts that Islamic banking has to relate its activities to faith if it has to distinguish itself from conventional financial institutions. Given this characteristic, it is imperative for Islamic banks to include social dimensions in their operations along with the normal banking practices. The question is how the social role of Islamic banks can be best exemplified in promoting small entrepreneurs.

One unique feature of Islamic banking and finance is the profit-and-loss scheme whereby all assets and liabilities are integrated, and with this arrangement, Islamic banking and finance are able to lend on a longer-term basis for projects or startup businesses that have higher or lower return characteristics. This will also promote economic well-being and growth. The most common types of financing used by Islamic banking and finance to support long-term businesses are Mudharabah (profit sharing) and Musharakah (joint venture). Existing literature highlighted that in view of the preference for profit/loss sharing scheme over other trading modes, Murabahah can also play a role as financing facility, given its permissibility. In addition, under the Murabahah scheme, the buy-and-sell financing, given equal instalments, is flexible, easier to understand, and simple to monitor (Suzuki and Uddin, 2016).

Kessler *et al.* (2007) mentioned that SMEs or startups encourage entrepreneurship and obviously will enhance economic expansion under the Islamic banking and finance setting. The products such as Murabahah, Mudharabah, and Qardhul Hasan under IB seem to be most suited for startup businesses and other equivalent businesses. Interestingly, Qardhul Hasan, Murabahah, and Ijarah financing are flexible in usage and easy to implement in determining capital needs (Qardhul Hasan), equipment and assets (Murabahah), and leasing (Ijarah) for SMEs (World Bank-IDB, 2015; Dhumale and Sapcanin 1998). Thus, plenty of financial schemes can be suitable for startup businesses, but they are also subject to the risk profiles of those particular businesses. For example, in the case of SMEs, the study by Hussein *et al.* (2015) shows that 95% of all financing of SMEs in 2003 were approved based on Ijarah, Bay Bithaman Ajil, and Murabahah financing schemes.

Looking at the offering patterns of Islamic banking and finance facilities, startup businesses can utilize these facilities, which will be useful for accelerating their businesses. The availability of these types of financing for various businesses, including start-ups, have been recognized by various parties, such as policy makers in many countries, as it is consistent with Shariah principles. The Organization of Islamic Cooperation (OIC) emphasizes the importance of the development of SMEs and startup businesses via active usage of Islamic financial products linked to real economic activity. Thus, it allowed various businesses in member countries to tap into the rapidly growing pool of Shariah-compliant funds. Nevertheless, the General Council for Islamic Banks and Financial Institutions, together with the Islamic Development Bank (IDB), keep finding the best innovative ways of financing to further accelerate the growth of businesses worldwide and promote the role of Islamic finance, especially the social finance aspect.

2.3 *Principles and Characteristics of Islamic Banking and Finance*

Principles and practices of conventional banking and finance (based primarily on the Western worldview) may be inconsistent with the Islamic worldview, since the Islamic worldview is different from the Western one. The Islamic worldview is based on the Quran and Sunnah (practice of Prophet Muhammad [pbuh]). Besides, the philosophy of

Islamic banking is in accordance with the Shariah (Islamic law/jurisprudence) (Haron and Nursofiza, 2009; Komijani and Taghizadeh, 2018), which states that Islamic banking and finance cannot deal in any transactions involving interest/riba (an increase stipulated or sought over the principal of a loan or debt). Further, they cannot deal in the transactions which have an element of Gharar (uncertainty) or Maisir (gambling) (Komijani and Taghizadeh, 2018) and in any transaction that has a subject matter that is invalid (prohibited in the eyes of Islam). Islamic banks focus on generating returns through investment tools that are Shariah-compliant as well. Operating within the sphere of Shariah, the operations of Islamic banking are based on sharing the risks that may arise through trading and investment activities using contracts of various Islamic modes of financing. The prohibition of a risk-free return and permission of trading, as enshrined in Verse 2:275 of the Quran, makes the financial activities asset-backed in an Islamic set-up, with the ability to cause "value addition" (Haron and Nursofiza, 2009). As a result, asset-based and equity-based contracts are promoted by Islamic finance as viable alternatives to conventional financing, which merely relies on an interest-based system. Besides, the philosophy of Islamic banking and finance emphasizes the ethical and social dimensions of financial transactions that enhance equity and fairness for general benefit of the society.

3. The Products of Islamic Banking and Finance for Small Businesses

The Islamic financing options for small businesses can be divided into two categories, namely (i) asset-based financing, and (ii) equity-based financing. These financing categories have been part and parcel of boosting the financial inclusion of small businesses and attracting prospective capital providers and sources. Asset-based financing instruments include Murabahah, Ijarah, Salam, Ar-Rahn, and Tawaruq. Meanwhile, equity-based financing instruments include Mudharabah, and Musharakah. Each of the instruments is illustrated graphically and explained briefly as follows.

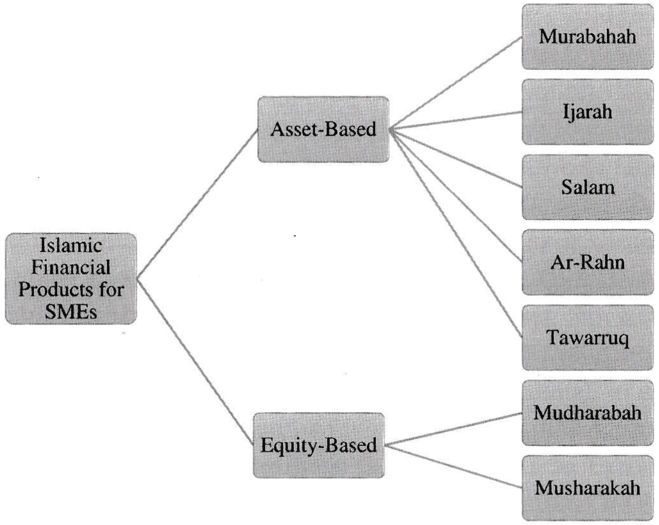

Figure 1: Islamic Financial Products

Source: Author's illustration.

3.1 *Murabahah Financing*

Murabahah is one of the most-applied forms of Islamic financial contracts made between a financing institution and a client whereby the financier buys assets (usually at a lower price) specified and required by the client and then sells those assets (usually at a higher price) to a client; the profit margin is the difference between the buying and selling prices of the assets that are paid by the clients mostly on an installment basis. Among the benefits of this product are (i) a fixed rate of financing throughout the period of financing; (ii) the disclosure of the price and mark-up; (iii) its use for short-term financing; and (iv) getting rid of collateral requirements.

3.2 *Ijarah (Ijarah Muntahiya Bi Tamleek Financing)*

Ijarah Muntahia Bi Tamleek (IMBT) is a form of leasing contract. This is a special leasing contract whereby legal title of a leased asset is transferred to the lessee after the expiry of the leasing period. At the end, as a

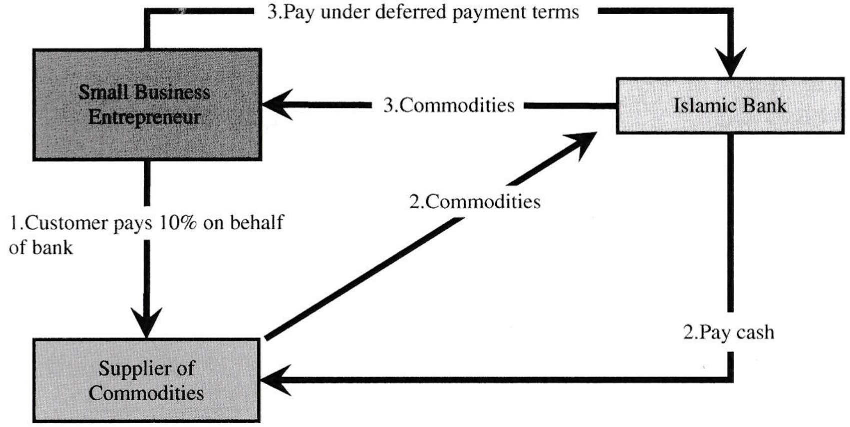

Figure 2: Modus Operandi of Murabahah Financing

Source: Author's illustration.

lessor, the financial institution or the bank hands over the ownership of the leased asset to the lessee, the client. The lesser here is entitled to claim all accumulated rental income, including the profit. The IMBT is adopted in several arrangements where the asset's ownership can be transferred, for example, the sale and transfer of the equity claim (from lessor to lessee).

3.3 *Salam (Parallel Salam Financing)*

Salam is another form of Islamic financial forward sale contract whereby the payment of the goods or commodities is paid in advance (present) (mostly agricultural goods) and the delivery takes place on the stipulated date (future). This kind of contact is beneficial for small agro-businesses that need working capital. Salam provides several benefits for small businesses: (i) provision of Shariah-compliant working capital, (ii) usefulness for short-term financing, and (iii) beneficial for the agricultural industry.

3.4 *Ar Rahn*

Ar-Rahnu is one type of short-term credit or loan (termed as Qardh in Arabic). The client will pledge gold or other valuable metals accepted as

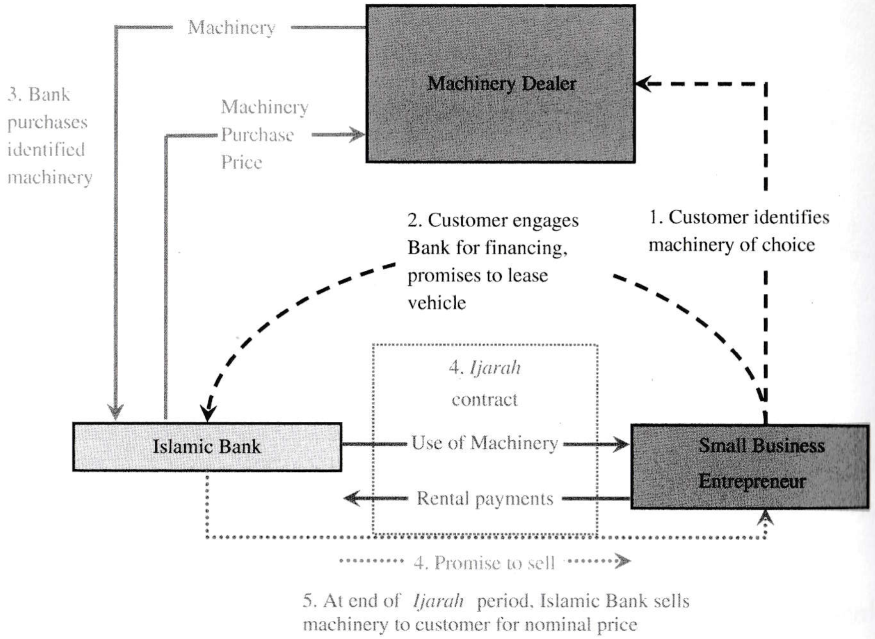

Figure 3: Modus Operandi of Ijarah Muntahiya Bi Tamleek Financing

Source: Author's illustration.

security, which act as the collateral for the loan. This special kind of contract is based on the principle of Islamic law (Shariah) under savings with guarantee or safe-keeping (Rahn and Wadiah Yad Dhamanah). Ar Rahn provides benefits such as (i) no interest, (ii) short-term financing for small businesses, and (iii) surpluses to be returned after auction in the case of default.

3.5 *Tawarruq Financing (organized Tawarruq)*

Tawarruq is another Islamic financing mode in which a series of sales contracts are involved in the entire transaction process. Here, a client buys a commodity from a seller (on a deferred basis) and afterwards sells the commodity to a third party (not the original seller, and on a cash basis), to obtain liquidity. This instrument provides benefits in terms of (i) liquidity management, (ii) suitability for meeting the needs of small business' working capital, and (iii) no collateral requirement.

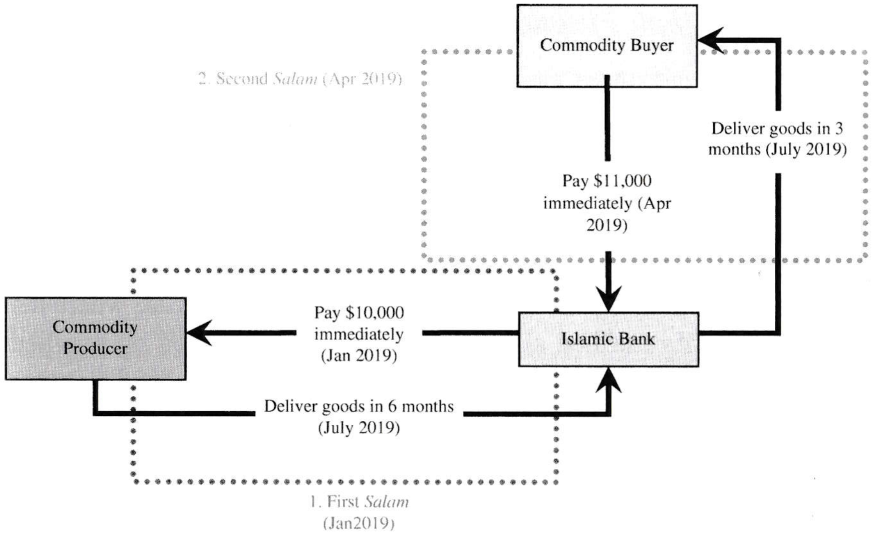

Figure 4: Modus Operandi of Salam (Parallel Salam Financing)

Source: Author's illustration.

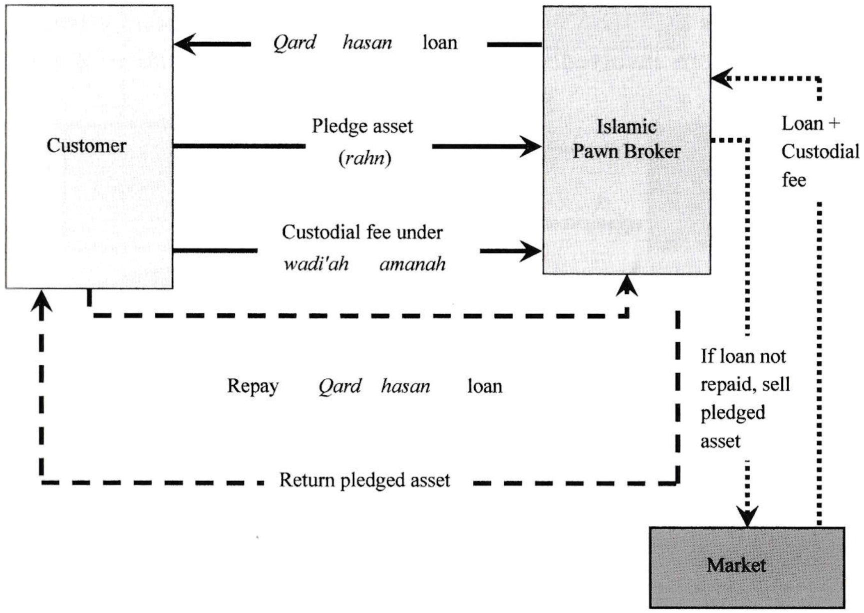

Figure 5: Modus Operandi of Ar Rahn

Source: Author's illustration.

3.6 *Mudharabah Financing*

Mudharabah is one of the ideal and most recommended Islamic financial modes of operations in which the business or project is managed/organized/run based on partnership. One party provides capital (called the capital provider or Rab-ul-Mal) and the second party manages the business (called the entrepreneur/fund manager or Mudarib). The profits (if any) are distributed based on the pre-agreed ratio, and the losses (if any) are borne solely by the capital provider except in the case where the fund manager has fulfilled all the responsibilities bestowed on him/her. If there is negligence in managing the funds or business, the fund manager or Mudarib is also liable for the loss amounts. The Mudharabah contact is very appropriate for small businesses because there is (i) profit sharing; (ii) the entrepreneur does not have to contribute capital to the joint venture; and (iii) there is the ability to negotiate the profit ratio.

3.7 *Musharakah Financing*

Musharakah is another ideal Islamic financial contract whereby two or more parties are involved, all of the parties provide capital to a joint

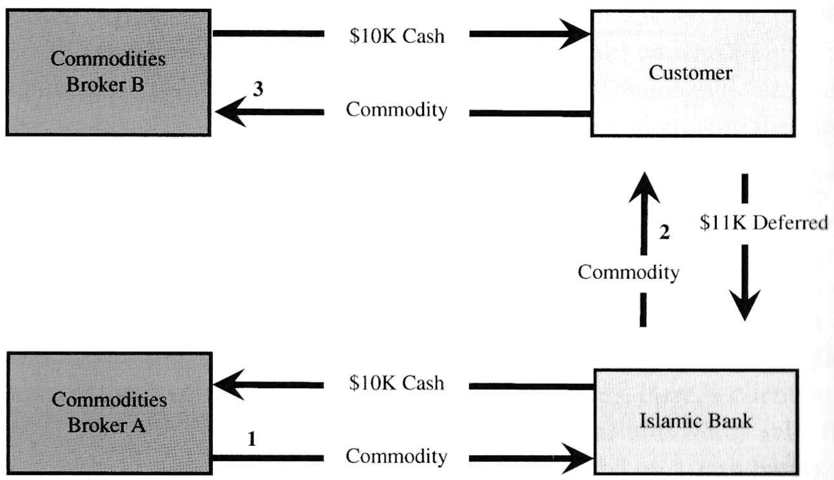

Figure 6: Modus Operandi of Tawarruq Financing

Source: Author's illustration.

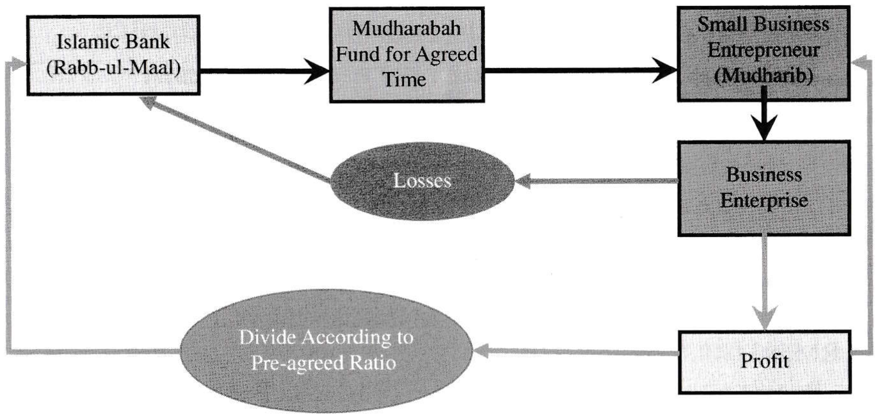

Figure 7: Modus Operandi of Mudharabah Financing

Source: Author's illustration.

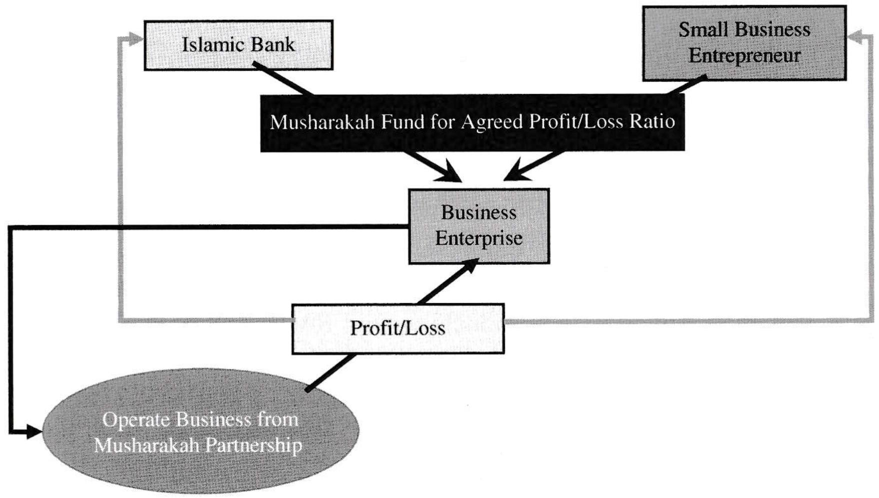

Figure 8: Modus Operandi of Musharakah Financing

Source: Author's illustration.

business or venture, they share the profits based on pre-agreed ratios, and losses (if any) are borne by all the parties proportionate to their capital contribution. The benefits of this particular instrument are (i) profit and loss sharing, and (ii) ability to receive the highest percentage of profits.

4. Mobilization of Islamic Banking and Finance Towards SMEs in Malaysia and Indonesia

The RAM Rating (2019) revealed that Islamic banks in Malaysia maintain strong growth as they continue to expand at a much faster pace than their conventional counterparts, with 11% in 2018 and comprising about 32% of the overall system's financing. Islamic banks are seen as a robust platform for assisting SMEs in accessing financing as BNM statistics in early 2019 indicated that Islamic banks in Malaysia held total assets amounting to RM682,048.4 million.

Recent research by the Association of Islamic Banking and Financial Institutions Malaysia (AIBIM) indicate that about 10,000 SMEs received more than 10 billion in funding (Kamel, 2019). A key indicator of the BNM reports is that RM4,716.2 million of total financing was disbursed as of November 2019 solely by Islamic banks for several sectors (Bank Negara Malaysia, 2019). The AIBIM asserts that Islamic banks granted RM20 billion worth of financing access to SMEs (Kamel, 2019). However, despite that, SMEs are seen as not fully utilizing various solutions provided by Islamic banks because a lack of awareness persists among SME entrepreneurs regarding the financing options obtainable.

A number of financing activities were traced to support the prodigious growth of the SME industry. Bank Negara Malaysia (2019) data depicted a steady growth of SME financing by type of Islamic product. For instance, Bai Bithaman Ajil's (BBA) products totaled RM64,488.9 million, Ijarah RM9,910.7 million, Ijarah Thumma Al-Bai RM72,423.0 million, Murabahah RM208,532.9 million, Musyarakah RM50,904.2 million, Mudharabah RM57 million, Istisna' RM2,059.8 million, and others RM103,284.0 million. Table 1 shows the total financing and increments in total financing disbursed by Islamic banks in support of SMEs' gradual advancement.

These financing products are found to be used for a number of productive purposes such as purchase of securities (RM316.2 million), purchase of transport vehicles (RM3,112.5 million), purchase of landed property (RM27,824.2 million), purchase of fixed assets other than land and buildings (RM1,189.1 million), personal uses, credit cards, purchase of consumer durable goods, and construction (RM6,280.8 million), mergers and acquisitions (RM22.8 million), working capital (RM38,019.5 million), and other purposes (RM3,820.0 million). Therefore, it is evident that a number of sectors are enormously aided through the financing facilities provided by Islamic banking and finance institutions to SMEs in Malaysia. For instance, the Bank Negara Malaysia (2019) reported these sectors included agriculture, mining and quarrying, manufacturing (including agro-based), electricity, gas and water supply, wholesale and retail trade, restaurants and hotels, transport, storage and communication, finance, insurance, real estate and business activities, education, health, household sector, and other sectors.

Table 1: Total Financing

Year	Total Financing (in RM million)	Increment in Percentage (%)
2014	335,385.1	–
2015	393,956.9	17.5
2016	436,708.4	10.9
2017	481,247.3	10.2
2018	511,660.5	6.3

Meanwhile, Islamic banks in Indonesia were established in 1991 and pioneered by Bank Mualamat. According to Otoritas Jasa Keuangan (OJK) data on June 2018, there were 13 Shariah commercial banks, 21 Shariah business units, and 168 Shariah rural banks. The largest providers of Islamic microfinance in Indonesia are 150 Islamic rural banks (BPRS) and more than 3,000 BMTs (Baitul Maal wat Tamwils), a network of Islamic financial cooperatives. Bank Rakyat Indonesia Syariah (BRI Syariah) is an important player. It is a subsidiary of Indonesia's largest microfinance institution, Bank Rakyat Indonesia (BRI).

In the last five years, Indonesia's Shariah banks have seen assets grow by 38% compared to 15% for conventional banks (Bank Indonesia). The sector is currently dominated by two leading players, namely Bank Mandiri Syariah and Bank Muamalat, which account for 50% of total Shariah financing between them (Global Business Guide-Indonesia, 2011).

The development of Islamic banks in Indonesia started two decades ago, and the conventional banks still covered almost 70% of the industry at that time. However, the trend of subsidiaries and the promotion of rational behavior in this industry will trigger more Shariah-based banking in the near future.

In terms of the financing contracts, more than 80% of the financing at the full-fledged Islamic banks in the country is based on three contract types — Murabahah (54%), Musharakah (34%), and Mudharabah (6%), adhering more closely to the classical Islamic model of economics than possibly any other country.

Figure 9 shows that most of the financing of Islamic banks is for the household sector. The financial intermediaries are the best indicators of usage of Islamic financial products in the economic sectors. Thus, real usage of the microenterprises in Indonesia is still the lowest, and this may be influenced by various factors such as the scale of borrowing within the five economic sectors. Most of the time, the usage of SMEs is less

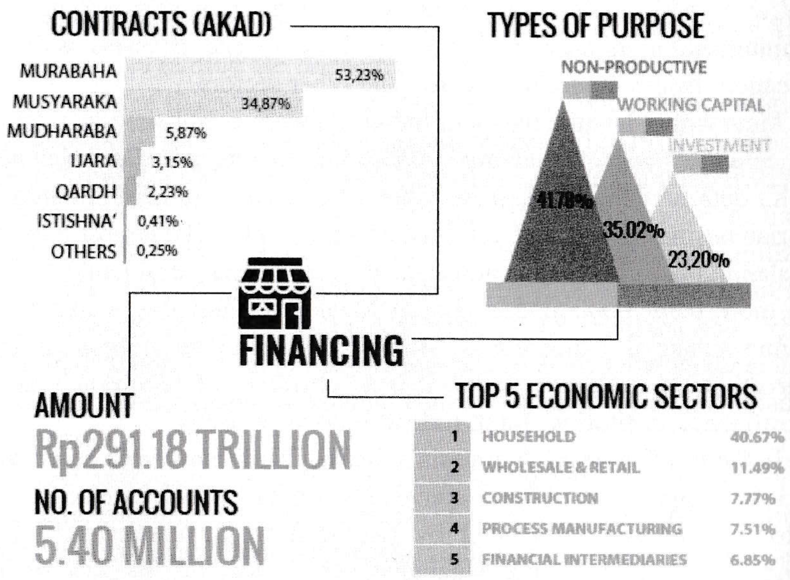

Figure 9: Usage of Islamic Finance Product

Source: Global Business Guide-Indonesia, 2011.

compared to the above five sectors. In addition, these indicators also reveal that expansion and demand for Islamic finance products in Indonesia is significant in the top five economic sectors.

Indonesia appears to be a natural growing market for Shariah-compliant banking services, given the size of the Muslim majority population; however, the character of the market is starkly different from that of neighboring Malaysia or the Middle East. The majority of Indonesia's potential Islamic banking customers fall under the "rational market" as opposed to that of the "spiritual market." Islamic banking products are therefore pitted against their conventional counterparts and judged on their commercial merits as opposed to being chosen on the basis of faith.

5. Challenges of Implementation of Islamic Finance for Small Businesses

Some of the challenges involved in Islamic finance implementation for small businesses are as follows:

(i) Product Offerings

The Islamic financial products offered to small businesses are skewed more toward debt financing such as Murabahah. Although there are other products such as Musharakah, Mudharabah, and Ijarah, Murabahah is more suitable for specific financing purposes, and these products come with better profit and loss sharing. Thus, there is no diversity in offering different financial products to support small businesses' financial needs. There is a need to move towards equity-based financing instead of just relying on debt-based financing.

(ii) Regulatory Framework

One of the crucial challenges for Islamic finance, regardless of whether it is for small businesses or other platforms, is the lack of a regulatory framework for financial products. Looking at conventional financing, the regulation standards are more harmonized and standardized, which makes their products more marketable and easier to follow. In Islamic finance, the products are less standardized since there are no approved standards per se for Islamic finance. Most of the Islamic finance products follow the conventional banking rules and regulations.

(ii) Transaction Costs and Non-movable Collateral

As far as Islamic finance for small business is concerned, the transaction costs and taxes involved are relatively higher compared to their conventional counterparts in financing. Possible reasons for this may be the Shariah verification processes and complicated taxation guidelines. Furthermore, small businesses generally facing the problem of non-movable collateral cause the Islamic banks to be reluctant to finance small businesses in general. Thus, a strong legal standard is needed in order to allow small businesses to utilize their movable tangible assets.

(iv) Knowledge and Information

The knowledge and availability of Islamic finance products for entrepreneurs, especially at the startup level, is still at a low level. This may be due to the limited number of Islamic finance products offered, and this industry is still at the beginning stage, compared to conventional banks. The Muslim majority countries such Malaysia, Indonesia, and others are moving toward full-fledged Islamic finance institutions, and this will lead to a better Islamic finance ecosystem.

(v) Smart Collaboration

Currently, the government and private sectors that offer Islamic finance products to small businesses are executing their roles individually. Smart collaboration such as shared capital, risk, training, and other responsibilities will attract more stakeholders, such as investors, to participate in the SMEs' investments as capital providers.

6. Conclusion, Policy Implications and Recommendations

To sum up, small businesses are playing a vital part in economies as they create employment and contribute to the national income. However, this sector faces many challenges, particularly in accessing financial services

in many countries, including Malaysia and Indonesia. This research has compiled the findings of a number of empirical studies that can be viewed from the financier's as well as the entrepreneur's perspectives. It has been observed that the financier is quite reluctant to provide finance to the entrepreneurs of small businesses. The main causes for most of the loan applications of entrepreneurs to be denied are their early stage of business establishment and lack of proper business experience, no collateral security, higher transaction costs, improper business planning, small size of loans, limited or lower production networks, lower sales, revenue, and cash-flows, and bad credit history. On the other hand, the entrepreneurs of small businesses criticized the financiers because of their rigid terms and conditions of loan approval. In addition, there are many other objections regarding the financiers that are related to inadequate information, insufficient advice, collateral requirements, transaction costs, loan amounts, interest rate and repayment period, loan maturity, lending processes, etc. Apart from highlighting these financing challenges, this research also discussed the government policies and programs of small businesses in Malaysia and Indonesia for the development of the industry. As can be realized from the discussion, these programs do not fully satisfy the financial needs of the small businesses.

The SME sector has many challenges, and one of the most important ones is the lack of required financing either to start up or to expand the existing enterprises. In this chapter, we have presented a number of Islamic financial products such as Mudharabah, Musharakah, Murabaha, Ijarah, and Salam which can be adopted to meet the financial needs of the entrepreneurs. Among these products, there are some that are short-term in nature, i.e., Murabaha, which is particularly appropriate for financing day-to-day business activities and for satisfying the requirement of working capital, which has higher risks than some of the long-term products, i.e., Mudharabah, Musharakah, Ijarah, and Salam, which are most appropriate for the economic viability of the businesses. Ideally, Islamic financial institutions should be focusing more on non-borrowing and long-term Islamic products or contracts to finance the long-term projects. As a possible solution for those challenges, the present research presents a few innovative Islamic financing modes, i.e., Mudharabah, Musharakah, Murabahah, Ijarah, and Salam.

Islamic financial products can be better alternatives or substitutes for conventional financial contracts, but they are not complementary to each other. This is because of the underlying fundamental principle involved in Islamic financial contracts that is guided by Islamic law or Shariah. The key difference between these two financial systems is the practice of interest or riba, uncertainty (Gharar), gambling, and speculation, which are not accepted under any condition by the Islamic financial system. In addition, the current practice of conventional financing in most of the cases is not based on partnerships with profit-and-loss sharing principles.

In real situations, there are many uncertainties that make businesses either profitable or failures. An entrepreneur who starts a new enterprise can face many business uncertainties. The entrepreneur can share the risks of conducting business with an Islamic financial institution as the partner. In this case, the institution can create a risk-sharing investment account on its liability side based on Mudharabah or Musharakah, whereas on its assets side, there could be the underlying contract with various Islamic finance products. Along with this, Islamic financial institutions, including banks, can get necessary support from government and its policymakers to fruitfully use equity-based financing contracts to better serve the SME sector.

Small businesses were observed to positively cultivate the supportive culture between the local public and private sectors (McFarland and McConnell, 2013) in which these acts contribute to substantial innovation, productivity, and dynamism in many countries. In relation to findings from this study, number of policy implications could be derived in leveraging the Islamic banking and finance for small businesses. First, local government should initiate programs to provide greater flexible sources of capital with engagement of Islamic banking and finance industry. The equity-based contracts offered by Islamic banks such Mudharabah and Musharakah can be structured and applied to enable better loan terms on the basis of risk sharing between the small businesses entrepreneurs and Islamic banks. Second, the Islamic banking and finance practitioner should construct viable Islamic investment products to encourage takers among small business entrepreneurs. Innovation of products could further assist the new involvement and gain of productivity of the market players. Next, the entrepreneurs themselves need to enhance their skills and talents in developing their business ventures and at the same time forage for Shariah-compliant financial loan assistance.

The present research recommends that a successful implementation of the innovative Islamic financing mode of operations can not only mitigate the existing financial challenges of small businesses, but it can also bring solutions to varieties of problems faced by the financiers in financing small businesses. Further research can be conducted on the suitability of each of the financing modes in different contexts, i.e., the nature of project or business, type of sector (agriculture or industry), market condition, and infrastructural and technological capacity. It is also hoped that after the successful assessment of all the possible factors, selecting the most appropriate Islamic financial modes can elevate the small business sector not only in Malaysia and Indonesia but also in some other parts of the world and thus contribute to economic growth and social welfare.

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Investment in Startups and Small Business Financing

Successful startups and small businesses can play a significant role in economic growth and job creation. They also contribute to economic dynamism by spurring innovation and injecting competition. Startups are known to introduce new products and services that can create new value in the economy. It is notable that most startups exit within their first ten years, and most surviving young businesses do not grow but remain small. Startups and small businesses face several obstacles to their development. Accessing capital is a crucial constraint on their growth. Most startups and small businesses have difficulties getting the funds they need because of their lack of a performance track record and lack of collateral, making it difficult for lenders or investors to assess their risk. Besides, they are in the early stages of development and face a very high possibility of failure, which significantly raises financing and investment risk.

Investment in Startups and Small Business Financing provides 12 thematic and case studies on new methods for bringing private investment (loans or equity) to startups and easing small businesses' access to finance (debt and capital). The contributors are senior-level policy experts and researchers from governments, think tanks, academia, and international organizations. The chapters are authored in a policy-oriented way to be understandable for the readers with a different background. This book is a precious source for the governments for adopting the right policies to develop small businesses and startups and valuable for the researchers in economics, business, and finance.

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ISBN 978-981-123-581-8